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Bankruptcy Judge  
2 United States Courthouse  
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4

5 UNITED STATES BANKRUPTCY COURT  
6 WESTERN DISTRICT OF WASHINGTON  
AT SEATTLE

7 In re )  
8 ) Chapter 7  
PRO AIR, INC., )  
9 ) Bankruptcy No. 00-09271  
10 Debtor. )  
11 ) **MEMORANDUM DECISION**  
12 ) **NOT FOR PUBLICATION**

13 This matter came before the Court on October 5, 2007, on the  
14 motion filed by Wembly, Ltd. and International Technology  
15 Investment Group, Ltd. (collectively "Movants") requesting the  
16 following relief: (1) that the Court enter an order allowing  
17 Movants an administrative expense claim in the amount of  
18 \$1,259,693.67; (2) that the Court require International Union,  
19 UAW ("UAW") to disgorge \$1,137,500 in payments it received from  
20 the Chapter 7 trustee in this case on its Section 364(c)(1)<sup>1</sup>  
21 superpriority claim; and (3) that the Court order the payment of  
22 Movants' allowed administrative expense claim from the funds  
23 disgorged by UAW. UAW and Robert D. Steinberg, the Chapter 7

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25 <sup>1</sup> Unless otherwise indicated, all Code, Chapter, Section and  
26 Rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101 *et*  
*et seq.*, in effect as of the petition date of September 18, 2000.

1 trustee (the "Trustee"), objected to the relief requested by  
2 Movants. The Court heard oral argument on October 5, 2007 and  
3 took the matter under advisement. For the reasons that follow,  
4 the Court will deny Movants' request that UAW be ordered to  
5 disgorge postpetition payments on account of its superpriority  
6 claim.

### 7 I. BACKGROUND

8 The facts pertinent to the motion are not disputed. On  
9 September 18, 2000, Pro Air, Inc. ("Pro Air" or the "Debtor")  
10 filed a Chapter 11 petition. Pursuant to various cash collateral  
11 orders, Pro Air was authorized by the Court to use the cash  
12 collateral of its major secured creditors, General Motors  
13 Corporation and DaimlerChrysler Corporation (collectively,  
14 "Secured Lenders"). Second Declaration of Christopher M. Alston  
15 In Support of Motion for Order ("2<sup>nd</sup> Alston Decl."), Exs. A, B,  
16 C. Under the terms of the orders, the Secured Lenders were  
17 granted postpetition liens against Pro Air's assets of the same  
18 type covered by their prepetition liens and priority under  
19 Bankruptcy Code §507(b) should their postpetition liens fail to  
20 adequately protect them from a loss resulting from Pro Air's use  
21 of their cash collateral. The orders granting this protection  
22 specifically provided, however, that the Section 507(b) claim of  
23 the Secured Lenders would be subordinate to Chapter 7  
24 administrative expenses in the event the case was converted to  
25 Chapter 7. *Id.*

26 In addition, an interim order signed by the Court on  
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1 November 13, 2000 authorized Pro Air to borrow up to \$1,050,000  
2 from UAW pursuant to the terms of a financing agreement.  
3 Declaration of Christopher M. Alston In Support of Motion for  
4 Order ("Alston Decl."), Ex. E. The interim order provided that  
5 UAW's claim for repayment of the funds would have priority under  
6 364(c)(1) "and/or" 507(b) "over any and all administrative  
7 expenses of the kind specified in §503(b) or §507(b)," but would  
8 be of equal priority to the claims of the Secured Lenders under  
9 Section 507(b). *Id.* The funds were to be used to pay Pro Air's  
10 ordinary operating expenses pursuant to a court-approved budget.  
11 A final hearing on the UAW financing was held on December 1,  
12 2000, at which time an order was entered approving the terms of  
13 the interim order without change. *Id.*

14 Pro Air was unable to confirm a Chapter 11 plan and on  
15 September 28, 2001, the case was converted to Chapter 7 and the  
16 Trustee was appointed. The Trustee, the Secured Lenders and UAW  
17 entered into a stipulation dated March 22, 2002 (the "Post-  
18 Conversion Stipulation"), which permitted the Trustee to use cash  
19 collateral that was in Pro Air's bank accounts on the conversion  
20 date and proceeds of unencumbered assets to fund the liquidation  
21 of Pro Air's estate. Alston Decl., Ex. G. The Secured Lenders  
22 specifically agreed that their collateral could be surcharged  
23 pursuant to Section 506(c) for the costs associated with the  
24 liquidation of their collateral. Pursuant to Section 11 of the  
25 Post-Conversion Stipulation, UAW agreed to subordinate its  
26 superpriority claim to the Trustee's liquidation expenses:

1 The UAW recognizes that in order for the Trustee  
2 to pursue avoidance actions under Section  
3 [Chapter] 5 of the Bankruptcy Code (in which  
4 Lender does not have a security interest), the  
5 Trustee must be assured that the fees and costs of  
6 the Trustee and his professionals are paid.  
7 Therefore, UAW expressly agrees that the  
administrative expenses (fees and costs) of the  
Trustee and his professionals in pursuing  
avoidance actions are granted priority over the  
superpriority granted to UAW in the DIP Financing  
Order, subject to the notice requirements of  
section 8 above.

8 Alston Decl., Ex. G, ¶11. Section 14 of the Post-Conversion  
9 Stipulation acknowledged that Pro Air was administratively  
10 insolvent and that there was an estimated amount of \$3,754,266.28  
11 in unpaid Chapter 11 administrative claims.

12 After the Post-Conversion Stipulation was approved on  
13 April 16, 2002 (see Alston Decl., Ex. G), the Trustee commenced  
14 collection of Pro Air's Chapter 5 causes of action, including  
15 preference and fraudulent conveyance actions. Multiple orders  
16 were subsequently entered pursuant to which the Court permitted  
17 payments to the Secured Lenders of proceeds of their collateral  
18 and payment to UAW of proceeds of collections from Chapter 5  
19 causes of action, net of the Trustee's expenses related to the  
20 proceeds. See Alston Decl., Ex. I. Pursuant to the orders, UAW  
21 was repaid \$1,137,500 of the amount of its postpetition loan,  
22 which amount paid the principal loan in full plus some, but not  
23 all, of the postpetition interest due on the loan.

24 On October 4, 2002, Movants filed a complaint for  
25 declaratory judgment against the Trustee and Shire Equipment  
26 Leasing Corp. ("Shire") seeking declaratory relief that Movants  
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1 were the owners of a stock certificate evidencing 1.1 million  
2 shares of Gundle/SLT Environmental Inc. (the "Gundle Shares").  
3 The Trustee answered the complaint asserting his right to the  
4 Gundle Shares pursuant to contracts between Pro Air and Movants.  
5 Shire also answered the complaint and filed a counterclaim  
6 against the Trustee as well as cross claims against Movants. See  
7 Adversary Case no. 02-01571. Subsequently, the adversary  
8 proceeding was transferred to the U.S. District Court for trial.

9 In 2003, the Trustee filed a motion for approval of a  
10 settlement agreement with Movants pursuant to which Movants would  
11 pay the estate \$50,000 in exchange for the Trustee's  
12 relinquishment of any interest in the Gundle Shares. Shire  
13 objected and made the Trustee a counteroffer. Subsequently, the  
14 Trustee withdrew his offer to settle with Movants and sought  
15 authority instead to enter into a settlement with Shire. On  
16 August 22, 2003, the Court approved the settlement between Shire  
17 and the Trustee (see Docket No. 1037), pursuant to which Shire  
18 paid the Trustee \$50,000 to acquire the estate's rights against  
19 Movants and to the Gundle Shares. Shire also agreed to pay all  
20 of the expenses of the litigation pending in the district court  
21 and to pay the Pro Air estate an agreed portion of any recovery  
22 in that action. Believing the estate had no obligation to  
23 participate directly in the litigation, the Trustee employed  
24 Shire's counsel as special counsel in the litigation to monitor  
25 the action for the estate. Alston Decl., Ex. O.

26 The litigation between Movants and Shire proceeded in  
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1 district court and, after a trial, the district court ruled in  
2 favor of Movants and against Shire on all of its counterclaims.  
3 On December 16, 2004, the district court entered a judgment in  
4 favor of Movants declaring them the owners of the Gundle Shares,  
5 which by that time had been converted into cash in the amount of  
6 \$20,350,000 as a result of a merger (the "Merger Consideration").  
7 Alston Decl, Ex. Q. Shire and the Trustee appealed the judgment  
8 and sought a stay pending appeal. The district court granted the  
9 stay so long as Shire and the Trustee established an escrow  
10 account into which the Merger Consideration was to be deposited  
11 to protect the funds pending the appeal. Alston Decl., Ex. R.  
12 In the order, the district court noted that interest accruing on  
13 the escrow account should be sufficient to cover any postjudgment  
14 interest Shire and the Trustee might ultimately owe and ordered  
15 the Trustee to surrender the Merger Consideration to the escrow  
16 agent. The Shire and the Trustee were to submit to the court  
17 proof that the conditions of the stay, *i.e.* the escrow  
18 requirements, had been met within 60 days of the date of the  
19 April 20, 2005 order. *Id.* The parties could not agree on the  
20 terms of the escrow, however, so none of them took any action  
21 with regard to the escrow account or the Merger Consideration.  
22 Two years later, the Ninth Circuit Court of appeals affirmed the  
23 district court in an opinion issued on March 1, 2007. Alston  
24 Decl., Ex. T.

25 In May of 2007, Movants sought to enforce their judgment to  
26 recover the Merger Consideration plus postjudgment interest and  
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1 damages. On May 2, 2007, the district court issued an Order  
2 Granting Motion to Enforce Judgment pursuant to which the court  
3 granted Movants' request for postjudgment interest at the rate of  
4 2.6% until the Merger Consideration was delivered to Movants.  
5 Shire and the Trustee contended that Movants had waived their  
6 right to postjudgment interest by refusing to sign an indemnity  
7 provision required by the proposed escrow agent thereby  
8 preventing establishment of the escrow account. The district  
9 judge held that Movants had not waived their right to  
10 postjudgment interest, but had waived only their right to  
11 security for the interest. Alston Decl., Ex. X. The court  
12 ordered Shire and the Trustee to pay interest at 2.6% from the  
13 date of the judgment, finding that had they turned over the  
14 Merger Consideration to Movants years earlier, they could have  
15 stopped the accrual of postpetition interest.

16 Movants then requested the district court to enter separate  
17 judgments against Shire and the Trustee for postjudgment  
18 interest. The Trustee argued that he had no involvement in the  
19 litigation, including the decision to appeal, but only a right  
20 pursuant to the settlement agreement with Shire to payment in the  
21 event Shire was successful in the litigation. Alston Decl.,  
22 Ex. Y. On June 11, 2007, the district court granted Movants'  
23 motion for the entry of a separate judgment against the Trustee,  
24 finding that Movants, who were not parties to the settlement  
25 agreement between the Trustee and Shire, had not released their  
26 claims against the Trustee and that the Trustee never sought to

1 be dismissed from the litigation or disavowed the appeal that was  
2 brought in the names of both Shire and the Trustee. The district  
3 court entered a judgment against the Trustee in the amount of  
4 \$1,259,693.67, plus postjudgment interest on that amount pursuant  
5 to 28 U.S.C. § 1961.

6 Neither the Trustee nor UAW disputes the amount or priority  
7 of Movants' asserted administrative claim for \$1,259,693.67.  
8 They argue that UAW should not be ordered to disgorge the  
9 postpetition payments it received in the amount of \$1,037,500 so  
10 that Movants can be paid. There are no other funds available in  
11 the estate to pay Movants.

## 12 **II. JURISDICTION AND VENUE**

13 This Court has subject matter jurisdiction pursuant to 28  
14 U.S.C. § 1334 and this is a core proceeding under 28 U.S.C.  
15 § 157(b)(2)(A).

## 16 **III. ISSUES**

17 Movants request the Court to resolve the following issues:

18 1. Whether Movants' Chapter 7 administrative expense claim  
19 has priority as a matter of law pursuant to Section 726(b) over  
20 UAW's superpriority claim under Section 364(c)(1) and Section  
21 507(b); and

22 2. Whether UAW should be required to disgorge postpetition  
23 payments made on its superpriority claim so that those funds can  
24 be applied to Movants' claim.

## 25 **IV. DISCUSSION**

26 Neither the Trustee nor UAW dispute that Movants are  
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1 entitled to the allowance of an administrative expense claim in  
2 the amount of \$1,259,693.67 pursuant to Section 503(b).  
3 Consequently, the Court has not considered the authorities cited  
4 by Movants in support of their claim, including *In re Megafoods*  
5 *Stores, Inc.*, 163 F.3d 1063 (9<sup>th</sup> Cir. 1998). See also  
6 *Abercrombie v. Hayden Corp. (In re Abercrombie)*, 139 F.3d 755  
7 (9<sup>th</sup> Cir. 1997). Additionally, UAW argues that the Court need  
8 not address the first issue above regarding the competition  
9 between Section 726(b) and Section 364(c)(1), but instead may  
10 decide the matter solely by looking at the disgorgement issue.

11 **A. Disgorgement.**

12 Assuming for the sake of this analysis that Section 726(b)  
13 gives priority to Movants' Chapter 7 administrative claim over  
14 UAW's Chapter 11 Section 364(c)(1) claim, the question is whether  
15 UAW is required to disgorge the payments it received on its  
16 Section 364(c) claim so that Movants' Section 507(b) claim can be  
17 paid. Although Section 726 establishes priorities for payment of  
18 claims in Chapter 7 cases, it does not provide for disgorgement  
19 if distributions are made in violation of the priority scheme set  
20 forth in that statute. The parties agree that there is no  
21 statutory authority for disgorgement other than Section 105,  
22 which provides that the Court "may issue any order, process, or  
23 judgment that is necessary or appropriate to carry out the  
24 provisions of this title."

25 The Ninth Circuit Court of Appeals has affirmed that  
26 although a bankruptcy court has the equitable power to issue any  
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1 order that is necessary or appropriate to carry out the  
2 provisions of the Code, a court may exercise its equitable power  
3 only as a means to fulfill some specific Code provision. See,  
4 e.g., *In re Saxman*, 325 F.3d 1168, 1174-75 (9<sup>th</sup> Cir.  
5 2003)(bankruptcy court is authorized to use Section 105 to  
6 partially discharge a student loan obligation consistent with the  
7 provisions of Section 523(a)(8)); See also *Norwest Bank*  
8 *Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S. Ct. 963, 99 L.  
9 Ed.2d 169 (1988) ("[W]hatever equitable powers remain in the  
10 bankruptcy court must and can only be exercised within the  
11 confines of the Bankruptcy Code."). Although some courts have  
12 ruled that disgorgement is mandatory if distributions have been  
13 made in contravention of Section 726's priority scheme, see,  
14 e.g., *Specker Motor Sales Co. V. Eisen*, 393 F.3d 659 (6<sup>th</sup> Cir.  
15 2004)(court ordered professional fee disgorged to achieve *pro*  
16 *rata* distribution), the permissive language of Section 105  
17 confirms what the majority of courts have held: that disgorgement  
18 is an equitable remedy that is within the discretion of the  
19 court. See, e.g., *In re Anolik*, 207 B.R. 34, 39 (Bankr. D. Mass  
20 1997)("Disgorgement is a harsh remedy, one that should be applied  
21 only when mandated by the equities of a case.").

22       There are numerous reported cases addressing the  
23 circumstances under which courts have found it equitable to  
24 require disgorgement. From these cases, three trends have  
25 emerged. First, courts have determined that disgorgement is not  
26 mandatory solely because of administrative insolvency. See,

1 e.g., *In re Kids Creek Partners, L.P.*, 220 B.R. 963, 978 (Bankr.  
2 N.D. Ill. 1998)(court denies disgorgement request where payments  
3 were made pursuant to court-approved settlement agreement), *aff'd*  
4 200 F.3d 1070 (7<sup>th</sup> Cir. 2000); *Anolik*, 207 B.R. at 39 ("This  
5 Court does not believe that Congress intended disgorgement of  
6 professional's fees due only to administrative insolvency.").  
7 Second, Courts seem more willing to require disgorgement from  
8 professionals who have received postpetition payments because of  
9 the additional discretion and flexibility courts have under  
10 Section 330 to approve fees. See, e.g., *Specker Motor Sales Co.*  
11 *v. Eisen*, 393 F.3d 659 (6<sup>th</sup> Cir. 2004); *In re Kearing*, 170 B.R. 1  
12 (Bankr. D. D.C. 1994)(court recognizes power to order Chapter 11  
13 professionals to disgorge interim compensation where Chapter 7  
14 estate is administratively insolvent).<sup>2</sup> Finally, no court has  
15 required disgorgement from a third party who received payment in  
16 the ordinary course of the debtor's business. See, e.g., *In re*  
17 *Florida West Gateway, Inc.*, 166 B.R. 981, 982-83 (Bankr. S.D.  
18 Fla. 1994) (Requiring vendors, suppliers, etc. to disgorge  
19 payments made during Chapter 11 "would virtually eliminate the  
20 ability of any Chapter 11 Debtor to operate."); *In re Western*  
21 *Farmers Association*, 13 B.R. 132 (Bankr. W.D. Wash. 1981); *In re*  
22 *Manwell*, 62 B.R. 533 (Bankr. N.D. Ind. 1986); *In re Vernon Sand &*  
23 *Gravel, Inc.*, 109 B.R. 255 (Bankr. N.D. Ohio 1989).

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24  
25 <sup>2</sup> At least one court has refused to require disgorgement  
26 from estate professionals when their fees were paid pursuant to a  
27 final fee order as opposed to an interim fee order. See *In re St.*  
*Joseph Cleaners, Inc.*, 346 B.R. 430 (Bankr. W.D. Mich. 2006).

1       There is no reported case in which a third-party,  
2 postpetition lender like UAW was required to disgorge payments  
3 received on its postpetition court-approved loan. Movants rely  
4 on *In re Kingston Turf Farms, Inc.*, 176 B.R. 308 (Bankr. D. R.I.  
5 1995), for the proposition that disgorgement may be required from  
6 a nonprofessional. In *Kingston*, the court ordered disgorgement  
7 of \$3,112 from a Chapter 11 vendor who was paid its  
8 administrative expense claim after persistent demands while other  
9 administrative expense creditors went unpaid. The court made the  
10 sweeping conclusion that "any payment received in such  
11 circumstances [where there is concern about an administrative  
12 cash shortfall] is a payment 'on account,' and is subject to  
13 review." *Id.* at 310. The court's opinion, however, was thin on  
14 legal analysis and was based on the court's view that  
15 disgorgement is required "as a matter of law, just to adhere to  
16 the mandatory payment scheme of the Code.... [*i.e.*, §726(b)]."  
17 *Id.*

18       In two cases cited by UAW, the courts refused to order  
19 disgorgement from third-party nonprofessionals. The circuit  
20 court in *In re Kids Creek Partners, L.P.*, 200 F.3d 1070 (7<sup>th</sup> Cir.  
21 2000), refused to deny the priority of a claim afforded to a  
22 secured creditor in the context of a court-approved settlement.  
23 The case did not involve conversion from Chapter 11 to Chapter 7,  
24 however, and the court did not mention disgorgement or  
25 Section 364(c)(1). Instead, the court concluded that "[o]nce an  
26 interim trustee has (with judicial approval) made a bargain on  
27 behalf of an estate in bankruptcy, then the estate is bound."

28 Memorandum Decision - 12

1 *Kids Creek*, 200 F.3d at 1073.<sup>3</sup> Similarly, in *Shop N' Go*  
2 *Partnership v. U.S.*, the court refused to order disgorgement of  
3 payments made to the Internal Revenue Service pursuant to a  
4 court-approved settlement in the Chapter 11 proceeding before  
5 conversion of the case to Chapter 7. 261 B.R. 810 (Bankr. M.D.  
6 Pa. 2001). The court rejected the trustee's argument that the  
7 payment should be disgorged because it violated the priorities  
8 established by the Bankruptcy Code, noting that because the  
9 payment was authorized by a final court order, the trustee could  
10 not recover the payment under the statutory authority provided in  
11 Section 549(a)(2)(B). Analyzing its equitable powers under  
12 Section 105, the court concluded that:

13           In the absence of an application of Rule  
14           60(b), policy considerations weigh heavily in  
15           favor of honoring the settlement agreement.  
16           Expectation of the parties that entered into  
17           the settlement agreement should be upheld.  
18           If not, neither the IRS nor the DIP would  
19           have entered into the agreement and there  
20           would exist a chilling effect on all future  
21           settlement agreements.

22 *Id.* at 817.

23           Based upon the discretionary language in Section 105, this  
24 Court concludes that disgorgement is not mandatory, and further,  
25 that it would be inequitable under the facts of this case to  
26 require disgorgement from UAW. UAW advanced significant funds to  
27 the debtor pursuant to a court-approved financing agreement at a

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28           <sup>3</sup> The lower court in the *Kids Creek Partners* case, however,  
ordered special counsel to disgorge his interim fees so that a  
*pro rata* distribution could be made to all other administrative  
expense creditors. *In re Kids Creek Partners, L.P.*, 219 B.R.  
1020 (Bankr. N.D. Ill. 1998).

1 time when the debtor was attempting to reorganize. The funds  
2 advanced were used to pay Chapter 11 operating expenses in the  
3 ordinary course of Pro Air's business. The financing agreement  
4 was initially approved nearly seven years ago and the last  
5 payment made to UAW was made nearly three years ago, pursuant to  
6 final court orders entered after notice to interested parties.  
7 There is no evidence to support Movants' contention that UAW  
8 financed the litigation with Movants nor did UAW have any input  
9 or decision-making authority regarding the litigation. Pursuant  
10 to the Trustee's settlement agreement with Shire, Shire had the  
11 sole authority to conduct the litigation. The fact that UAW, as  
12 Pro Air's largest unsecured creditor, would have received the  
13 largest share of any funds recovered from the litigation for the  
14 Pro Air estate does not make UAW liable for the adverse  
15 litigation result.

16 The equities of the case do not favor Movants. Although the  
17 district court held the Trustee and Shire responsible for the  
18 failure of the escrow arrangement and the claim for postjudgment  
19 interest, as between Movants and UAW, only Movants could have  
20 prevented their loss. UAW had no ability to alter the result or  
21 in any way force compliance with the district court order to  
22 escrow the Merger Consideration. There is no evidence, as  
23 suggested by Movants, that UAW was "monitoring" the litigation.  
24 Movants could have protected themselves by asking the district  
25 court for direction when the escrow arrangements could not be  
26 completed or by enforcing the judgment against the Trustee (the  
27 stay pending appeal never went into effect by the terms of the

28 Memorandum Decision - 14

1 district court order). Movants were well-aware that there were  
2 no significant assets in the Pro Air estate. The district court  
3 found that they waived their right to security for accruing  
4 interest on the Merger Consideration. UAW is not responsible for  
5 that waiver.

6 **B. Section 726.**

7 Because the Court finds that equity does not require  
8 disgorgement from UAW, it is not necessary to address the  
9 question of whether priority under Section 364(c)(1) trumps the  
10 scheme of distribution under Section 726(b).

11 **C. Trustee's Negligence.**

12 UAW makes the argument in its response to Movants' motion  
13 that Movants' loss should be assessed against the Trustee because  
14 of the Trustee's alleged negligence in failing to effect the  
15 terms of the escrow ordered by the district court. This claim is  
16 moot given the Court's ruling herein, and in any case, could not  
17 be addressed outside the context of an adversary proceeding. See  
18 Bankruptcy Rule 7001.

19 **CONCLUSION**

20 For the foregoing reasons, the Court will enter an order  
21 granting Movant's request for allowance of an administrative  
22 expense claim and denying Movants' request that UAW disgorge  
23 funds paid to it by the Trustee.

24 DATED this 24<sup>th</sup> day of October, 2007.

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26 KAREN A. OVERSTREET  
27 UNITED STATES BANKRUPTCY JUDGE